THE RICHEBÄCHER LETTER

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Tangible Trouble

> **"Although exciting, the great financial booms in retrospect have been intense periods of short-lived paper prosperity, not well savored in consequent hard times. Regrettably, there is no evidence in the literature of policymakers ever curbing a great inflation in financial assets or preventing the consequent fallout...Importantly, inflation in financial assets has never led to inflation in tangible assets."**
>
> **— Signs of Fatigue, Robert Hoye, Quantum Research**

We would re-phrase the tail-end of the above quote to say that inflation in financial assets has never led to a *sustainable* inflation in tangible assets. In essence, however, Mr. Hoye's point is on target. Ultimately, financial asset inflation leads to a hard deflation of both financial and tangible assets. Witness Japan in the late 1980s.

The financial asset inflation in the U.S., and its attendant wealth effects, are only now beginning to affect tangible assets, most notably real estate. In this letter we explain why this inflation too will be temporary, and that ultimately real estate values will collapse with the bull market.

More fundamentally, we address the credit excesses that are at the root of all bubbles. We note that Freddie Mac and Fannie Mae have taken on starring roles in both the stock and real estate markets, enabling other financial institutions to offload loans on their books in order to create new loans. But these credit excesses extend through all facets of the U.S. economy — in the real estate market, in the stock market, in the credit-fueled consumption binge that is fueling the current, unsustainable economic expansion.

As global credit creation has ceased to be anchored by money or deposit growth, bubble effects are proliferating throughout the U.S. economy. We expect the situation to get critical in the second half of the year.

RESURGENT BULLS

Disencumbered from the fear of profit disappointments after the passing of the reporting season, and embracing an optimistic perception that the worst of the Asian crisis has passed, it's once again a return to "business as usual". The old bull is back.

Indeed, it now looks like the widely anticipated "January effect" was but only delayed a month or so by Asian worries and a slew of poor profit reports and, generally, unimpressive fourth quarter earnings throughout. Now, enjoying the interval between reporting seasons, investors enthusiastically return their focus to the so-called "Golden Age" of strong economic growth, low inflation, low interest rates, and an accommodative Fed seen shackled by the fear of the Asian contagion. Earlier worries are happily replaced with much more palatable, at least for the bulls, watchwords such as "momentum" and "liquidity".

Quite obviously, Wall Street and corporate America are determined not to let the Asian crisis and a deteriorating profit environment temper the sea of money flowing into the stock market. Major mergers and acquisitions now occur on an almost daily basis with a plethora of high profile companies while a plethora of other high profile companies announces major stock buyback programs. Candidly, it is hard for us to argue with the bulls who trumpet once more a "liquidity driven" market.

Certainly exacerbating this spectacular market rally has been an unwind of bearish bets, especially in technology stocks. The tech-heavy NDX/NASDAQ 100 index and the Morgan Stanley High Tech Index have one-month gains now approaching 15 percent while the SOX/Semiconductor Index has gained 20 percent.

Even more bullish has been the financial sector. Brokerage and bank stocks shine with double-digit gains while several credit card companies have scored gains approaching 30 percent. As the small caps have joined the blue-chips, albeit to a lesser extent, it has turned into a broad-based advance — one particularly painful for the bears. All the same, we fully expect deteriorating profits to eventually spoil the party. Whether this begins with the coming preannouncement period and first quarter earnings reports, only time will tell.

We think so.

THE NEXT BUBBLE TO BURST

Anyone knowledgeable in economic and monetary history is well aware that booming "bubble economies" have regularly been mistaken for economic miracles. This glowing misperception tends to be evoked by the coincidence of three typical bubble features: first soaring asset prices generating tremendous wealth effects; second, low goods price inflation; third, strong economic growth. Thus the U.S. economy in the late 1920s, the Japanese economy in the late 1980s, and more recently the Southeast Asian economies. In fact, it lies in the very nature of "bubble economies" to look like the best of all possible words, until the bubble bursts.

To be sure, compared with the economic malaise in Europe and Japan, the U.S. economy appears today a paragon of supreme economic health. Unemployment and inflation are at their lowest levels in a decade. Unique in the world, the Federal Budget is also approaching surplus. Last year, the economy grew by nearly four percent, doing much of the job of keeping the global economy moving forward.

According to Wall Street lore, the U.S. economy has transformed itself into a "new economy" that can grow faster than before, without kindling inflation. Behind this, it is argued, is the explosion in computer power, corporate restructuring and intense global competition, which in addition have suppressed inflation to lows not seen since the early 1960s.

YET THE WEAKEST GROWTH IN THE POSTWAR PERIOD

What such eulogies overlook in the first place is the fact that, by historical standards, the U.S. numbers for the 1990s make in reality very poor reading. Economic growth has, in actual fact, been the lowest in the whole postwar period. The average rate of increase in real GDP in the eight years 1989 to 1997 inclusive has been 2.5 percent a year, of which 1.6 percentage points accrued from employment and 0.9 percentage points from productivity gains. This compares with an average of 3.1 percent in the 1980s and an average of 3.9 percent between 1948-73, of which 1.6 percent derived from employment growth and 2.3 percent from productivity gains.

Or, speaking of living standards, average weekly earnings rose in the 1960s a cumulative 15.4 percent (in 1982 dollars). A slight fall in the 1970s accelerated in the 1980s to a net decline of ten percent.This wage deflation continued until 1992. Over the five years since then, there has been a cumulative increase of three percent, with a slightly accelerating trend in 1997. Though this first modest increase is surely nothing to write home about, it has instantly caused general lamenting that wages are rising too fast. Corporate America has been pampered by low wages.

For European onlookers, confronted with relentlessly rising mass unemployment at home, the stellar U.S. employment performance is, understandably, the focus of admiration. So far in the 1990s, an increase in U.S. employment by more than ten million contrasts dramatically with a decrease in Europe by about seven million. Like everybody else, we appreciate this stunning difference, but, unlike others, we see no reason to give credit for it either to Messrs. Clinton, Greenspan or to the "new economy". Strong employment growth has in the United States been the established pattern over the whole postwar period.

Nevertheless, something is new, and that was in 1997 the confluence of surging economic growth and declining inflation. More than anything else, this is for many American economists the conclusive evidence that the U.S. economy must have experienced some "miraculous" transformation. Conventional explanations vary between the merits of Mr. Greenspan and the virtues of high tech and the "new economy".

These differences are grotesque. How do they come about? In short, mainly through the way the Commerce Department measures computer output and investment in real terms. The high tech products have two particularities: exploding computational power and collapsing prices. To capture both effects, the Commerce Department has developed a so-called hedonic price index for office, computing and accounting machinery (see the October 1997 issue of this letter).This statistical device, which it has applied since 1986, is supposed to capture not only the steep fall in computer prices but also inherent additions to computer capacity and quality — in short, "computer power". In combination, the two translated in the GDP statistics in real terms to exploding computer output and investment. It heavily added to U.S. real GDP growth without involving actual spending of money or placing any strains on productive capacity.

The big surge in high tech actually began as late as mid-1995. Just when the cyclical recovery, after a sluggish start, seemed to abort (see chart below), high tech took off at breakneck pace. Until then, spending on information technology had risen no faster than overall GDP. From then on, however, fully one-third of U.S. real GDP growth has come from the high tech sector.

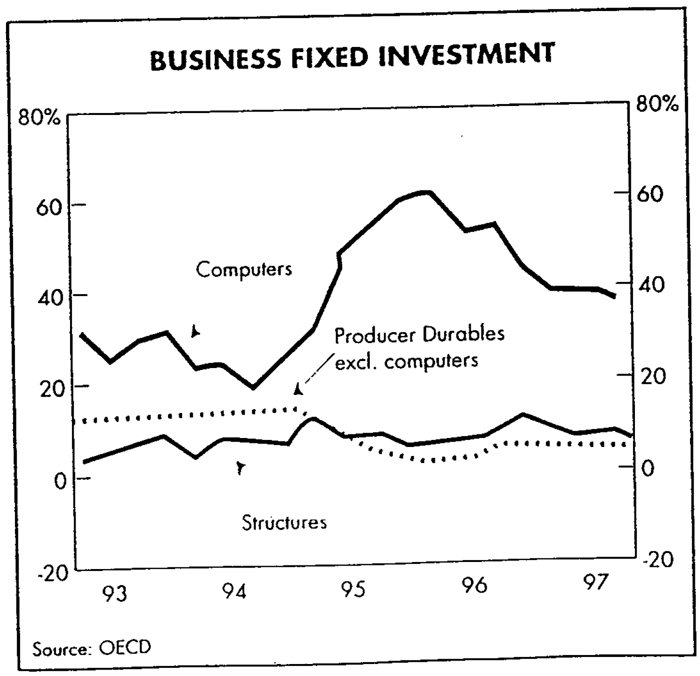
Closer examination, indeed, leaves no doubt that the unique nature of this U.S. expansion — combining faster growth with less inflation — has one overriding cause, and that is the unprecedented predominance of the high tech sector with plunging prices and soaring productivity growth. High tech rules.

With its colossal statistical contributions, this tiny sector has become a ruling factor for economic growth, productivity and inflation. However, there is a paradoxical twist to this statement, of which very few are aware. It lies in the fact that the measured big productivity gains have by no means accrued from the rapidly spreading use of computers but rather from the surging output of computer manufacturers. This distinction is of utmost importance as it essentially implies all the poorer productivity growth in the rest of the economy. In short, the technology-led productivity miracle has been taking place in just that single, narrow sector — nowhere else. It has eluded the economy as a whole.

THE HIGH TECH PARADOX

Like everybody else, we admire the fabulous progress of the new information technologies. Yet we continue to ask ourselves how better information technologies translate into improved efficiencies in tangible production techniques. Doesn't it need equipment for production in addition? Wondering about this question, it strikes us that computer investment has in the United States roared ahead in splendid isolation from other kinds of business investment (see graph at right). Between 1992 and 1996 inclusive, the net stock of U.S. Producers' Durable Equipment has increased overall by 17 percent, but with its computer component up by 308 percent.

Corporate America is spending in excess of $220 billion annually on high tech hardware, and three to four times that amount on software and related outlays. This compares with total nonresidential fixed investment of about $850 billion in 1997. It is argued that businesses, using computers and improved communications to manage inventories, are avoiding past excesses. Considering the numbers, one should rather wonder whether the greatest excess and imbalance is not in the spending on computers. Above all, it seems absurd to think that ever higher spending on it can go on for years to come.



CONSUMER-LED VERSUS INVESTMENT-LED GROWTH

This brings us to the key difference between the business cycle in the United States and that of most other industrial countries. Traditionally, economic recoveries have always and everywhere been led by rising business investment in response to low interest rates and new investment opportunities. Consumer borrowing for purposes other than housing was unknown. Investment activity was the tail that wagged the economic dog, leading consequently to increased consumer income and spending (the so-called, "multiplier principle").

From this traditional business cycle pattern, the U.S. economy began to diverge in the 1920s and 1930s. With consumer borrowing coming into fashion in the United States, American economists developed a new theory that assigned the leading role in the business cycle to changes in the demand for consumer goods, proclaiming that investment activity depends upon the rate at which consumer demand expands (the so-called, "accelerator principle").

In line with this thinking, first President Hoover and later President Roosevelt pursued policies of trying to boost primarily consumer demand. This was done partly through higher wages and partly through deficit spending. In early 1936, war veterans received government bonds for pension rights equivalent to almost four percent of GDP, for which they could claim immediate cash. Typically also, the introduction of a heavy tax on retained profits was supposed to increase dividend payments to stimulate consumer spending.

Consumer spending duly soared in 1936-37, but once the money was spent, the economy promptly collapsed again. Between August and December 1937, the production of investment goods fell by 51 percent, and the production of consumption goods by 13 percent. Together with the French economy, which under a Socialist government was treated with the same medicine of higher wages and big deficit spending, the U.S. economy failed to regain the 1929 level of economic activity. The obvious chief cause of the aborted recovery was inadequate investment.

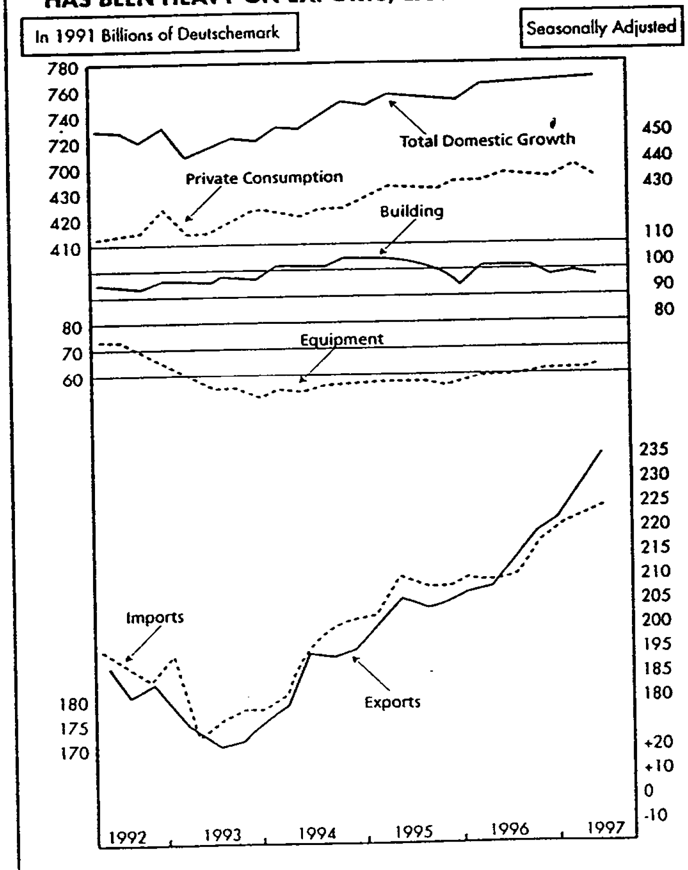
And today? In Europe, economic growth has definitely been broken by wage and fiscal excesses, while Japan and Southeast Asia chose to ruin their economies with investment excesses. America is the splendid exception, with consumer-led growth. However, this is fueled neither by high wages nor by deficit spending, but by consumer borrowing and the wealth effects from asset inflation — a completely new ploy. If this works in the United States, why not in Europe and Japan?

Two reasons: first, consumer borrowing is grossly underdeveloped in comparison to America; second, the public's participation in the stock markets is much too small for wealth effects to matter.

In these countries, therefore, any sustained economic recovery continues to depend in traditional fashion on exports and investment. While the strong exports have materialized, investment spending refuses to respond (see graph at right). As a result, the Japanese and most European economies remain stuck with low growth; and, so far, we see nothing that could change this for the better.

For good reasons, American policymakers and pundits are in denial that the U.S. recovery is bubble-

GERMANY'S ECONOMIC GROWTH HAS BEEN HEAVY ON EXPORTS, LIGHT ON INVESTMENT



Source: Bundesbank

First: astronomic money and asset creation through the international repo markets (mainly carry trade with cheap currencies) is financing asset speculation;

Second: there is a general flight out of cash and into securities;

Third: there are huge circular flows of money roaming in and out of countries, and in and out of markets, with the net effect of ever-rising global financial leveraging. The same money is many times invested and re-invested, imported and re-exported.

THE BIG QUESTION MARK FOR 1998

While the markets are blossoming again, we should not neglect to look at the economies and their prospects. Can we count on improvement, or must we reckon with deterioration? In its recent Interim Assessment of the World Economic Outlook, the International Monetary Fund has revised downward its growth projection for 1998 by 0.8 percentage points, to 3.5 percent. Southeast Asia, Latin America, and Eastern Europe account for the bulk of the cut, but a substantial slowing is also projected for the U.S. economy, from 3.8 percent in 1997 to 2.4 percent in 1998.

For the time being, the financial markets have hailed the Asian shock as a fortunate antidote to inflation. While the downtrend in inflation is sure to continue, it is conveniently ignored that the risks in the global economy are all on the downside. Europe's fledgling, export-led recovery is showing signs of sputtering; Japan's fragile economic recovery will be further undermined by adverse spillovers from the Asian crisis; and contagion effects from the Asian crisis are threatening the deficit countries of Latin America and Eastern Europe.

In light of these facts, the final outcome for the world economy crucially depends on what happens to the U.S. economy. Not since World War II has the world's economic well-being been so linked to the economic strength and health of the United States. Will it be able to act as the "buyer of last resort", and bail out the Asian countries without serious damage to its own growth and the dollar?

Our answer is categorical: No.

Such hopes are built on sand because the U.S. economy's recent strong growth — as repeatedly explained — is bubble-bred. The danger for the U.S. economy — and, by the way, also for the dollar — is that in the course of this year a drastic deterioration in the trade balance will converge with a pronounced slowing of the economy, entailing sooner or later rate cuts by the Fed.

For many market observers, the dollar's underlying fundamental strength is proved by the fact that it has in the last three years sharply appreciated against all other currencies even though the U.S. current-account deficit ballooned from $129 billion to an estimated $170 billion last year. The "safe haven" argument of the 1980s is back in fashion.

Yes, but what has happened all the other years? Hasn't the dollar been falling most of the time since it was set floating in 1972? Since 1985, it has come down from DM 3.20 and ¥ 263 to DM 1.82 and ¥ 129. Still, this long-term decline of the dollar has been repeatedly interrupted by strong transient recoveries. What was it that triggered these recoveries? That seems to us the opportune question, when trying to assess the dollar's longer-term outlook

In short, the key to the dollar's strength or weakness lies in the U.S. capital account. The general rule is as follows: In the long run, a currency's strength or weakness is determined by the trade and current-account balance. As to the short run, however, it has been traced back as far as World War I that the dollar's posture in the markets depends predominantly on the cyclical position of the U.S. economy and associated interest rate differentials. In times of strong U.S. economic growth and high U.S. interest rates relative to the rest of the world, capital and credit inflows tend to exceed the current-account deficit, boosting the dollar. At other times, which was most of the time, the dollar tends to fall.

bred. Instead, they cite low inflation, high profits and booming employment as the great fundamentals that drive the economy. The trouble with this argument is that most of these goodies, including the booming stock market, reflect in reality something else: excess liquidity and credit, dangerously imbalancing the economy and the financial system.

Speaking of healthy fundamentals, the things to look at are four, no more, no less: the savings ratio, the investment ratio, the rate of productivity growth, and the balance of payments. But it happens that the U.S. economy is in all four categories extraordinarily weak. ~~Its strength is that of a~~ of a "bubble economy", implying ~~that the existing asset bubble~~ is substantially impacting the economy. While Continental Europe's booming stock markets also clearly rank as "bubbles", they are not affecting the economies.

MORE HOT MONEY THAN CAPITAL

At the recent IMF conference in Hong Kong, President Mahathir of Malaysia made himself the laughing stock, calling currency trading immoral and blaming his country's problems on Soros' Quantum Fund. Ironically, Soros himself has argued at length in his book The Alchemy of Finance that such trading should indeed be regulated. The standard counter-argument, propagated not only by Wall Street pundits but also by the International Monetary Fund, is that fully liberated financial markets and international capital flows are the indispensable requisite for efficient capital allocation.

If the financial community laughs at the argument of the President of Malaysia, we consider this idea that unfettered capital flows necessarily translates into efficient international capital allocation even more laughable. The astronomic sums of money crossing global financial and currency markets today have nothing to do with "capital" and have everything to do with unfettered global money creation for financial speculation and a virtual collapse in liquidity preference on the part of investors and private households. This has brought about plunging short-rates and low inflation. In both respects, there is no comparable experience in history

Financial deregulation, innovation, globalization and global monetary looseness have given the world financial system the power to create money and credit literally without any limit. Associated with the ongoing unbridled monetary overexpansion has been an unprecedented flight from cash into securities. In the train of these developments, international financial flows have attained outright absurd dimensions. What's slopping around in world financial markets in vast amounts is not capital or savings; it is hot money.

During 1996, the United States had a net capital inflow essentially equal to the current-account deficit of $148 billion. But this net figure resulted from total inflows of $547 billion and total outflows of $352 billion (with a statistical discrepancy of $46.9 billion). During the first nine months of 1997, a net inflow of $119 billion derived from $494.8 billion of inflows and outflows of $320.5 billion.

The capital flow numbers for Germany make for even more absurd reading. In 1996, a trifling net inflow of DM 20 billion arose from massive inflows of DM 221 billion and outflows of DM 201 billion. Over the first three quarters of 1997, inflows totaled DM 283 billion, as against DM 272.3 billion outflows. Fantastic figures, for sure. On balance, however, there was a net inflow of barely DM 10 billion. Clearly, this net capital inflow was far too small to have had a significant effect on the markets or the economy. Yes, but DM 95 billion flowing into German bonds, taking up 44 percent of total new issues, certainly played a decisive role in lowering German bond yields.

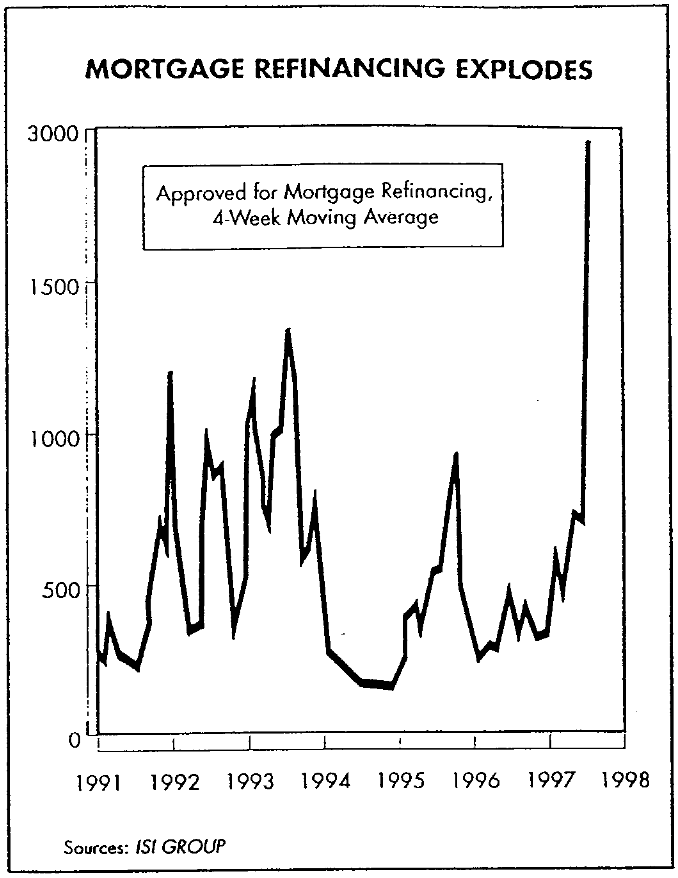
In the U.S. case, foreign official and private purchases of U.S. Treasury securities hit in 1996 a record sum of $300 billion. That was nearly three times the annual Federal deficit and therefore unquestionably the chief bullish influence in the market. On the other hand, there were $352 billion in capital outflows flooding the financial markets in the rest of the world.

So, what is really going on here?

In short, three things:

Yet the hype about the wonders that the rapid proliferation of high tech is doing to the U.S. economy lives on, fueled in large part by the conjectural evidence of surging corporate profits, low inflation, and a spectacular bull market in financial assets. While these are truly extraordinary results, they have in reality nothing to do with a meaningful breakthrough on the productivity front

Riding a wave of a technological mania, the related industries have over the last years grown at a pace vastly in excess of the rest of economy, crucially helping to extend the expansion. But with high tech having grown so big, the economy is now vulnerable as never before to a high-tech slowdown, which is only a question of time. It has definitely acquired the features and the dimensions of a "bubble".



THE U.S. CONSUMER BUBBLE

The other unsustainable booming demand component in the U.S. economy, equally with distinct bubble characteristics, is the ongoing consumer-spending binge. The odds are that over the next few months consumer spending will even accelerate. Home mortgage refinancings (refi) have zoomed to levels never seen before. Capitalizing on the decline in longer-term rates, homehowners refinance their mortgages at cheaper rates, frequently taking out larger loans, lowering thus their home equity. Periods of heavy refi activity have always been periods of strong consumer spending. As the graph on this page shows, it has this time literally exploded.

Refi, stocks, home prices, tax refunds, auto bonuses, confidence, etc., are all up. As we shall explain in this letter, the financial system is firing on all cylinders to accommodate consumer spending — and another bubble: real estate.

There is one simple test for the existence of a consumer spending bubble: a sharply declining personal savings rate. This rate is the focal aggregate that promptly and accurately reflects and registers any irregular bulge in consumer spending, essentially financed from sources other than income growth — in the actual case mainly from debt creation and wealth effects. In reflection of these two excesses, the U.S. personal savings rate has since 1992 plunged from six percent to 3.5 percent of disposable income, an unprecedented low. According to the Fed's Flow of Funds Accounts, the rate is even as low as 2.5 percent.

In other words, the key driver of the U.S. economy's recent strong growth was a virtual collapse of private savings. To speak under this condition of extremely healthy economic growth is really the height of economic ignorance. It has created a belief in a "free lunch", where consumers think they can raise their spending levels, while soaring stock prices take care of their retirement.

As an aside, while surging spending on new information technologies has boosted overall capital spending to a level not seen since the mid-1960s, there has been no concomitant follow-through in spending on the nation's productive capital stock, equipment and structures. An annual average growth rate in the 1990s of two percent marks the slowest pace of capital accumulation in the whole postwar period.

High tech assets are short-lived assets, implying high rates of depreciation.

This was spectacularly true from 1982 to 1985, and it is true again since 1995. In this light, there is nothing unusual about the dollar's current strength. It corresponds with the established cyclical pattern. These same cyclical considerations lead us to predict a steep fall of the dollar later this year under the impact of a surging trade deficit and a distinct slowing of the economy. Estimates for the rise in the current-account deficit range from $50 billion to $100 billion. Add to this a probable rate cut by the Fed and a crashing stock market, and there are the ingredients for a most severe dollar crisis.

THE "GRANDDADDY OF BUBBLES"

At times, we have been inclined to view the global securities boom as one big Wall Street-inspired speculative bubble. Today, however, we are faced with the dichotomy of a breathtaking financial and economic collapse in Asia on the one hand, and record-breaking equity markets in the U.S. and Europe on the other. In other words, numerous related but separate bubbles thrive even while others have so rapidly and painfully deflated.

But the "Granddaddy of Bubbles" is, of course, the financial and economic boom running so out of control in the United States. In adamant disagreement with the vast majority of today's sanguine "new era" adherents, we see an economy now commanded by unprecedented credit excesses and the resulting consumption boom.

As the booming U.S. stock market garners the most headlines, dangerous but largely ignored inflation in tangible assets has begun to flourish throughout. Prices continue to escalate for single-family homes, condominiums, apartment buildings, office buildings, hotels, raw land, radio stations, cable television networks, professional sports franchises, casino properties, amusement parks, golf courses, luxury yachts, cruise liners, marinas, funeral homes and cemeteries, cellular phone franchises, car dealerships, internet-related businesses, fine art, and so on.

Both in Japan and Southeast Asia, the developing bubbles were easily recognizable in rampant credit expansion. But policymakers and the markets closed their eyes and focused instead on the good-looking inflation rates, as measured by the conventional price index, as the only gauge that matters. Pretty much the same mistake is now being made in the United States.

BUBBLES ARE CREATED BY CREDIT EXCESSES

Over the last twelve months, U.S. *bank* lending increased by $270 billion, or nearly ten percent. This was virtually equal to nominal GDP growth. Though this is exceptionally strong, it grossly understates the actual overall credit expansion, owing to heavy and rapidly growing securitization of credit, which is mostly financed through the money markets. Significantly, this implies credit creation without deposit or money creation. Alternatively, money velocity rises. It's thus a clear case of credit monetization.

This credit boom is now also affecting real estate.

Apart from the grossly inflated stock market, we see now progressive overheating in the U.S. real estate market, contrasting paradoxically with global deflation in commodity prices. Witness falling prices for oil and energy products, grains and agricultural products, beef, hogs, technology components and consumer electronics, oceanic shipping rates, lumber, paper, copper, steel, aluminum, lead, leather, cotton, and so on. However, this strange divergence has its logic in the fact that the commodity deflation assures the markets of the persistence of loose money.

With an unfettered U.S. financial system "firing on all cylinders", aggressively financing endemic asset market inflation, one is left pondering the harm that is done to the economy and the financial system. Remembering that the greatest and, hence, most problematic credit and speculative excesses transpired during the final years of the booms of the late 1920s in the United States, in the late 1980s in Japan, and recently in SE Asia, we are cognizant that the U.S. is now in a similarly perilous period.

shareholders' equity advanced $8.2 billion. Freddie's assets, meanwhile, ballooned 316 percent, or $148 billion, as shareholder's equity grew less than $5 billion.

So, over the past six years of this roaring, liquidity-driven bull market, Fannie and Freddie have combined to increase their balance sheets by almost $400 billion. 97 percent of this has been financed by additional debt, largely through the money markets. Analysts and economists who focus on the growth of loans and demand deposits of commercial banks as the fuel for economic growth are looking in the wrong place.

With today's housing boom and inflation exerting a strong, albeit unsustainable, multiplier effect directly on economic growth, it also provides additional collateral which homeowners have extensively used to borrow for consumption as well as stock purchases. This, inarguably, is an integral facet of today's bubble economy.

To repeat: to grasp the egregious credit expansion fueling today's U.S. bubble, look above all at Fannie and Freddie!

Wall Street adores Freddie and Fannie. Indeed, shareholders have been handsomely rewarded, with 12-month gains of almost 50 percent and, already another ten percent in 1998. Over the past six years, both stocks have risen nearly 350 percent. Much to the delight of Wall Street, both agencies have, regardless of their rapid expansion, also been aggressive purchasers of their own stock. In 1997 Fannie bought back almost 31 million shares, while Freddie reduced its shares outstanding by almost 30 million. Both financed these purchases with borrowings in the money markets.

But Wall Street's interest goes much beyond just stock performance. Indeed, securities firms profit greatly in their role as the dealers for Fannie and Freddie mortgage-backed securities and debt instruments as well as by actively marketing derivative products to these companies. So, recognizing the key roles they play in both the equity and credit bull markets, it is little wonder why Wall Street is such a strong proponent of both companies.

In several respects we see Fannie and Freddie — with their $1.3 trillion of mortgage-backed securities, bloated leveraged balance sheets, and minimal capital positions exacerbated by massive stock repurchases — as symptomatic of a financial system running out of control and straight into trouble.

Another example of huge leveraged holdings in mortgages can be found in Real Estate Investment Trusts (REITs). Borrowing aggressively *in the money markets too*, many of these trusts heavily leverage in residential and commercial mortgages, enticing investors with hefty dividend yields on their tiny equity base.

This is a credit bubble *par excellence*. The financial leverage here applied is even for America of unprecedented scope, and still escalating. Taking place outside the banking system and therefore without any visible trace in the money supply, these financial excesses go virtually unnoticed. Principally, it is of course in line with the famous, massive "carry trade", borrowing short and investing in higher-yielding bonds. But while the carry trade dominates global bond markets, here the borrowed money is being poured into the real estate market.

Given the extremely accommodative lending environment in the United States, this specific credit bubble not only fuels real estate inflation. In addition, it readily provides and fosters a mechanism where borrowers not only lower their debt payments by cheap refinancings but also can "cash in" on housing inflation through higher home equity borrowing (see graph on page 5). The refi mechanism, then, allows borrowers to not only lower their interest payments but also to raise their loans. In fact, the issuance of home equity-backed securities soared to $55 billion last year, a 70 percent increase from 1996. There is little doubt that much of this amount was spent either for consumption or for playing the stock market.

It is our long-held view that the Fed has become hostage to the extreme leverage that has developed in the U.S. financial system. It no longer dares to hike its interest rate for fear of wreaking havoc on the markets and the whole financial system, as it did in 1994. With far greater leverage today, such a move would entail the risk of causing a financial collapse. And the markets know this. Continuous loose money is thus assured, and this spurs ever more financial leverage.

According to the National Association of Realtors, single-family home sales for 1997 reached a record 4.21 million units, three percent above the previous record in 1996. At the same time, housing starts during 1996-97 registered the strongest two-year period in history. The median price for December 1997 was $125,800, almost 6 percent above the previous year, as sales rose 8.6 percent. The largest price gains were in the South and West, with gains of 8.1 percent and 7.6 percent. In California, spectacular real estate inflation has returned with a vengeance! According to the California Association of Realtors, the median price in December was $189,990, 10.5 percent above the previous year. In fact, the price of a typical residence in the "Golden State" increased $22,000.

Not surprisingly, the greatest gains were achieved near Silicon Valley. The median price in Santa Clara county rising 21.4 percent to $341,370 on a unit sales increase of 19 percent. In San Francisco prices rose almost 16 percent as rents have risen 25 percent. In addition, Southern California also participated, as a 24 percent gain in unit sales fostered an average ten percent price appreciation in Orange County. Similar booms are reported in the greater Seattle, Boston and New York areas, not coincidentally closely tied to booming financial markets.

Though these numbers do not appear as alarming as were previous episodes of real estate inflation, they are very disconcerting when recognized as part of a general nationwide real estate and asset inflation in conjunction with overheated financial markets. It is also reported that the national rate of home ownership has risen to a record 65.7 percent. This has certainly been spurred by the move toward lower down-payment requirements and ever more lenient credit standards.

Essentially, every great inflation is matched by an equally impressive credit explosion. It is not too difficult to identify the powerful credit-creating mechanism presently fanning U.S. housing inflation; just look at the balance sheets and mortgage securities of Fannie Mae and Freddie Mac, who, in close partnership with Wall Street, have completely transformed the mortgage financing industry. Historically, home mortgages have been problematic for lenders, entailing difficult prepayment patterns and cyclical defaults — as was the case in the S&L crisis. But through the alchemy of modern finance, home mortgages have now turned into prime marketable securities. At least that is what Fannie and Freddie must believe to have achieved.

LOOK AT FREDDY AND FANNY

With little fanfare, Fannie Mae has quite aggressively inflated its balance sheet. Total assets now surpass those of Chase Manhattan, the largest U.S. bank. Currently, less than $14 billion of shareholder equity supports over $390 billion in assets, largely mortgages and related investments. This skinny 3.5 percent equity coverage does not include another $579 billion of mortgage-backed securities which Fannie has securitized and sold, hence guaranteeing the timely payment of interest and principal. During just 1997, Fannie grew its balance sheet by almost $41 billion, as against an increase in shareholder's equity of less than $1.3 billion. Backed by an "implied" federal government guarantee, Fannie Mae has certainly "pushed the envelope."

Working hard so as to not be left too far behind, Freddie Mac pushed its balance sheet holdings of mortgages in 1997 by 20 percent, or almost $27 billion. It now holds $195 billion in assets supported by a mere $7.5 billion in shareholder's equity. In addition, it has off-balance sheet mortgage security guarantees of $580 billion. For the fourth quarter alone, Freddie grew its balance sheet by more than $10 billion, with shareholder's equity up a mere $373 million.

As part of their aggressive policy to grow earnings through ballooning balance sheets, the two agencies now purchase the majority of all new mortgage-backed securities for their own accounts. This leaves traditional mortgage lenders, such as banks, S&Ls and insurance companies, free to increase their holdings of other assets.

Looking back several years, one is left with little doubt as to the momentous role these two institutions have played in the overheated U.S. credit markets. In what is clearly one of history's great credit expansions, Fannie Mae has since the beginning of 1992 expanded total assets by $245 billion, or 167 percent, as

Trying to form our own opinion, we notice first of all that sharply slowing consumer and producer price inflation is a global phenomenon. It has gripped all countries, irrespective of economic strength or weakness.

In Ireland, consumer price inflation has over the last three years decreased from 2.8 to 1.8 percent against the backdrop of eight percent annual real GDP growth. In Spain, a plunge in the inflation rate from 5.2 percent to two percent has coincided with annual economic growth of 2.5-3 percent. Italy's inflation rate is down to 1.6 percent, also from well over five percent just three years ago. Considering this global development, there is definitely no reason to attribute the decline in the U.S. inflation rates specifically to a singular economic miracle in the world.

Besides, we see quite a variety of inflation-containing influences, other than a miracle: the surge in the dollar; falling energy prices; and a downward adjustment in the CPI by the U.S. Bureau of Labor Statistics to reflect quality improvements. But above all, it is the explosive growth in **high tech output** that has made the crucial contribution in the United States to strong growth and low inflation.

A CHRONIC INFLATIONARY BIAS

Yet we emphasize that the U.S. economy has in reality a chronic inflationary bias which has two main reasons: first, persistence of excess domestic demand growth as strikingly reflected in the persisting, large trade deficit; and, second, the lowest savings and investment ratios among the industrial countries as reflected in the low productivity gains of barely one percent annually. Both influences continue to be at work. In contrast, Europe's main source of inflation has been a persistent, inordinate wage push, which the soaring unemployment has finally broken.

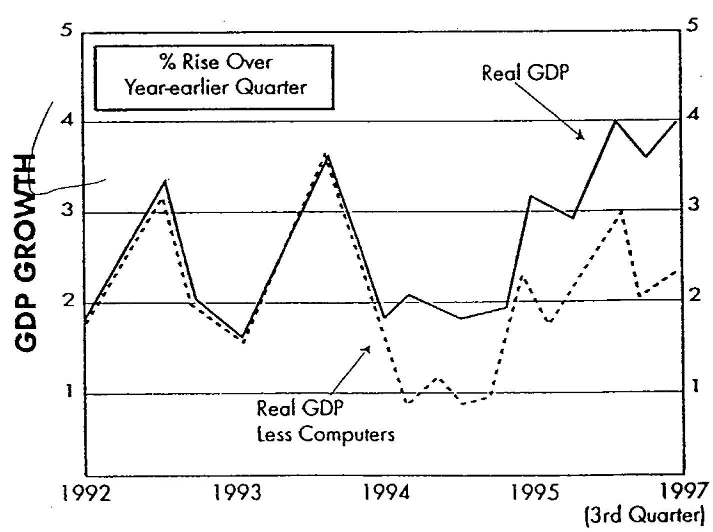
But hasn't the U.S. Labor Department just announced a productivity spurt to 1.7 percent in 1997 following a 1.9 percent rise the year before? These figures compare with an average rate of 0.85 percent per annum recorded between 1990-95. Has the long-predicted payback from the technology binge finally arrived?

The short answer: No, it hasn't.

First of all, this spurt is simply too abrupt to be believable; productivity miracles don't happen overnight. And second, we have identified two major statistical snags that distort recent productivity gains heavily to the upside. The first one is about the accuracy in measuring the hours worked in the economy. To the extent that work time is underestimated, productivity growth is overstated. Embedded in the official productivity statistics is an average weekly work schedule per worker of 35 hours, as measured by a monthly survey of business establishments. But according to private polls and the government's companion survey of U.S. households the average workweek is closer to 40 hours and even higher.

An even greater distortion in measuring U.S. productivity gains arises most probably from the recent explosion in computer output. To give an idea of the inherent statistical intricacies, first the astounding facts: During the two years from 1994-96, the output of "electronics and other electronic equipment" rose in current dollars by 8.2 percent. In chained (1992) dollars, it skyrocketed by 49 percent, six times as fast. Again in current dollars, high tech accounted in this period for 8.8 percent of total growth in manufacturing output. In chained (1992) dollars, though, for 55 percent.

COMPUTER-HEAVY GDP GROWTH



Source: Business Week
Data: U.S. Department of Commerce

Does this mean that this bubble play can go on forever? Definitely not. But if monetary tightening — the principal cause of bursting bubbles — is out of the question, what will or can prick this bubble? Just look at Asia. There, currencies and markets have crashed in the absence of any monetary tightening. What did it, instead, was simply a falloff of capital flows to the economies now in crisis — triggered by a sharp slowdown in their economic growth and soaring trade deficits — which then spread like a bush fire throughout the region. By the way, this is precisely the scenario that we envisage for the U.S. economy later this year, and which makes us wary of the dollar. Deficit countries regularly get into trouble when their economies weaken.

As earlier explained, we expect the U.S. economic situation to get critical in the second half of this year. For sure, the economy is overheating, but it is our crucial assumption that in the given global deflationary environment this will translate far more into a soaring trade deficit than into rising prices. This will substantially bite into GDP growth, and also into profits. Far from strengthening the dollar, this is the mixture that tends to weaken it. Considering that the whole world is massively long the dollar, there might be a dramatic turnaround, hitting capital flows and thereby the U.S. capital markets.

CONCLUSIONS:

Importantly, rampant inflation in financial assets has never led to inflation in tangible assets but to hard deflation of both. Low CPI inflation is being claimed as a result of smart central bank policy. Ironically, negligible consumer and wholesale inflation has been the hallmark of the worst financial bubbles in this century: the U.S. in the late 1920s and Japan in the late 1980s. Actually, it is *the* prerequisite to sustain excessive monetary looseness. Consumer or wholesale inflation has indeed been negligible in all the previous financial booms.

In his testimony in late February, however Alan Greenspan acknowledged that the outlook for the US economy this year is highly uncertain, with risks finely balanced between a renewal of inflationary pressures and a sharp slowdown that could dampen overall activity and prices.

Nonetheless, the financial markets appear oblivious to any possible dangers. Instead, investors take delight in the two most immediate effects from the Asian crisis that appear benign: downward pressure on prices and lower interest rates. But these benign effects are temporary, and will be followed later by painful adjustment processes.

Later this year, the U.S. dollar will resume its secular bear market since 1971, owing to a surging trade deficit, a slowing U.S. economy and impending rate cuts by the Fed.

As for Europe, even if the European Monetary Union should actually start as planned on January 1, 1999, the next recession will knock the air out of EMU. Stick with the hard currencies in Europe.

Bonds should beat stocks in the coming years as a combination of Asian crisis, global earnings downgrades and possible recession will throw cold water on the 1990s bull market in stocks. ■

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